W

W

W

W

What are patronage refunds?

?

?

?

?

U.S. DEPARTMENT OF AGRICULTURE
FARMER COOPERATIVE SERVICE
FCS INFORMATION 34

CONTENTS

FCS Information 34 Revised April 1977

What are patronage refunds?

David Volkin
Senior Agricultural Economist,
Organization and Finance

Patronage refunds or patronage dividends are terms distinctive to cooperatives. Rebate is the term more often used in other businesses.

The Internal Revenue Code of 1954 as amended,[1] defines a "patronage dividend" as ". . . an amount paid to a patron by an organization, to which part I of this subchapter applies—

1. on the basis of quantity or value of business done with or for such patron,

2. under an obligation of such organization to pay such amount which obligation existed before the organization received the amount so paid, and

3. which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that:

A) such amount is out of earnings other than from business done with or for patrons, or

B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions."

We use the Internal Revenue Service (IRS) definition as a basis for achieving some understanding of the term "patronage refund" because the IRS definition provides legal status and guidelines for implementing the cooperative concept of operating on a "service at cost" basis. We prefer to use the term "refund" rather than "divi-

[1]See Section 1.1388-1(a)(1) of the income tax regulations.

dend" because the latter carries the connotation of a return on capital where the term "refund" carries more of a "rebate" connotation. And reference to the IRS language makes clear that a return on capital is not intended by the IRS definition.

BASIC REQUIREMENTS

The IRS definition does point up certain key requirements that should be clarified and emphasized.

First, the definition refers to *patrons* rather than *members* of an organization operating on a cooperative basis. And because a key element of patronage refunds requires that they be made pursuant to a contractual arrangement between the cooperative and its patrons, there exists a basis for either including or excluding certain classes of patrons from such contractual arrangement. Thus it is possible to include only members as recipients of patronage refunds by virtue of their compliance with the cooperative's organization papers, and to include or exclude nonmembers through separate patronage refund agreements.

Second, an important difference that distinguishes an organization that operates as a cooperative from the noncooperative business organization is the requirement that such distributions are based on the ". . . quantity or value of business done with or for such patron." This requirement implements the cooperative's central objective of distributing financial benefits to patrons based on their use of the cooperative's services rather than on the basis of their investment in the cooperative's capital structure.

Third, because cooperatives may provide many varied services and patrons may vary widely in the nature and scope of their patronage, it would be reasonable from a patron's point of view for a cooperative to departmentalize its operations and its accounting procedures to more accurately determine the amounts available for distribution as patronage refunds based on the specific transactions of patrons.

Fourth, the IRS definition makes it clear

that patronage refunds arise only from transactions with its patrons. Thus, income that a cooperative receives from so-called "unrelated" activities are per se not derived from patronage transactions and would not be included in the IRS definition of a patronage refund. Such distributions, however, may be computed and distributed on a patronage basis in compliance with Section 521 of the IRS Code. Examples of nonpatronage income would include income items such as rental income, interest income, and capital gains.

Fifth, the obligation of the cooperative to pay patronage refunds must exist *before* any patronage transaction takes place. Thus, both the cooperative and its patrons have knowledge prior to any transaction that net margins derived from the transaction will be paid in whole or in part as a patronage refund. A typical bylaw provision that sets forth the obligatory nature of a patronage refund reads as follows:

"The association is obligated to make payments of all such amounts in excess of operating costs and expenses in cash refunds or by credits to a capital account for each patron."

Under such a preexisting mandatory obligation to pay patronage refunds, it is clear that a cooperative's board of directors has no discretionary posture as to whether the cooperative will or will not pay a patronage refund. That decision already exists. The board's purview lies only in the decision area of the *time* and *form* of the patronage refund, not *if* it will be made.

The preexisting obligation must be in enforceable written form. Valid examples include a cooperative's bylaws, articles of incorporation, marketing agreement, sales receipt, or other written contract obligating the association to make such payment. If a State law makes such patronage refunds mandatory, that law also is considered as a valid obligation.

Sixth, patronage refunds are distributions of net earnings (net margins or net savings) derived from business transactions with or for patrons. A question as to what constitutes "net earnings" may come up. The Federal income tax regulations define net earnings as ". . . the excess of

amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items."[2]

Under some circumstances, marketing cooperatives may operate in such a manner as to return all sales proceeds, less all expenses, to its patrons. Because such a cooperative generates no net earnings, it will pay no patronage refunds. At the same time, however, it may build its capital structure by patrons furnishing capital evidenced by per-unit capital retain certificates, based on the dollar value or physical volume of products marketed through the cooperative. Such capital is *not* furnished "by reference to the net earnings of the organization." Rather it is furnished on the basis of the patrons' marketing transactions through the cooperative.

Seventh, inherent in most definitions of what a cooperative is and the principles that distinguish a cooperative from a noncooperative form of business organization is the concept of equitability or fairness. The IRS definition preserves and reflects that concern by emphasizing that the term "patronage refund" does not include distributions derived from earnings from patronage transaction with patrons to whom the cooperative paid no patronage refunds or tc whom the cooperative paid smaller amounts witl respect to substantially identical transactions.

Relation of Patronage Refunds To Cooperative Features

How do the various features and key ele ments that explain patronage refunds relate tc and have an impact on basic cooperative charac- teristics?

Four characteristics are hallmarks of the cooperative form of organization. They are:

1) Member ownership and control
2) Service at cost
3) Limited returns on capital
4) Obligation to finance

[2]See Section 1.1388-1(a)(iii) of the regulations.

Member Ownership and Control

As patrons increase their equity interest in their cooperatives as a result of receiving patronage distributions in the form of allocated equities, their ownership interest increases. But their patronage, the resulting patronage allocations, other forms of participation in the affairs of their cooperative and, in fact, their loyalties, are unequal. As a result, some cooperatives, as a means of achieving their perceived interpretation of equitability adopt a system of weighted voting that takes into account members' investments arising primarily from their proportionate use of their association.

Based on this analysis, many associations have adopted weighted or proportional voting in preference to the one-member, one-vote method. In other words, patronage refunds appear to contribute to a shift from democratic control to so-called equitable control.

Service at Cost

Patronage refunds strengthen the operation-at-cost concept. One point of view is that because costs cannot be estimated accurately in advance, patrons of a cooperative usually pay the "going or competitive price" for goods or services and generally receive an advance or the going market price for products marketed that is less than the actual value of the product. Adjustments are made at the end of the year when costs are known. The amount of any necessary adjustment then goes to member-patrons as refunds based on patronage, thus reducing the operation to a cost basis. The refund results in the cooperative not making a profit for itself nor for nonpatron investors.

Limited Returns on Capital

Members of a cooperative are primarily interested in the benefits they derive as patrons of the organization. Because benefits in a cooperative are distributed to patrons on the basis of

their use of its services, such benefits do not enhance the value of shares of stock or other equity capital, or provide a return on invested capital.

Hence, members of a cooperative must provide most of its capital either by direct subscription or by investment of their patronage allocations. The incentives that cause persons to invest in corporate stocks are not present in the case of cooperative stock. For this reason, the capital of a cooperative, for the most part, can come only from its member-patrons.

On the other hand, as equities fall into hands of persons no longer using the cooperative's service, some mechanism should be triggered to either redeem such equities or to shift the character of such equities to provide a return to their holders.

Obligation to Finance

A cooperative is organized for the benefit of its members as patrons and not as investors. A cooperative patron's return on investment is reckoned in terms of improvement in farm income by use of the cooperative's services, not in terms of returns on capital furnished. Member-patrons are the persons primarily interested in and benefiting from the success of the enterprise. As they use its services, they assume the basic responsibility of providing capital through their investment of their share of the earnings derived from their patronage transactions.

But as patronage terminates so also does the financing responsibility end. Unless a cooperative adopts some plan or system to redeem equities held by persons who no longer patronize their cooperative, an anomalous situation of an increasing amount of ownership capital being held by inactive farmer-patrons grows.

Thus, patronage refunds are a natural and consistent ingredient to assure that member-patrons finance their cooperative. But unless equity redemption procedures are adopted, they are also a means of permitting equity capital to fall increasingly into the hands of those who no longer use the cooperative's services.

OTHER PUBLICATIONS AVAILABLE

Handling Net Margins Under Federal Tax Law. FCS Information 39. Revised September 1976. 8 pp.

Using Co-op Members' Money. C. H. Kirkman, Jr. FCS Information 79. Revised 1975. 16 pp.

Federal Income Taxes. Part II—Legal Phases of Farmer Cooperatives. Morrison Neely. FCS Information 100. May 1976. 126 pp.

How Farm Marketing Cooperatives Return Savings to Patrons. Donald R. Davidson. FCS Research Report 7. 1970. 81 pp.

A Financial Profile of Farmer Cooperatives in the United States. Nelda Griffin. FCS Research Report 23. 1970. 95 pp.

How The Adjustable Revolving Fund Capital Plan Works. Nelda Griffin. FCS General Report 111. 1963. 8 pp.

Methods and Policies Used in Making Patronage Refunds By Selected Cooperatives. Donald R. Davidson. FCS General Report 137. 1966. 22 pp.

For copies, write Farmer Cooperative Service, U.S. Department of Agriculture, Washington, D. C. 20250.

FARMER COOPERATIVE SERVICE
U.S. DEPARTMENT OF AGRICULTURE

Farmer Cooperative Service provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The Service (1) helps farmers and other rural residents obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs.

The Service publishes research and educational materials and issues *Farmer Cooperatives*. All programs and activities are conducted on a nondiscriminatory basis, without regard to race, creed, color, sex, or national origin.